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SIPDIS

ENERGY FOR CDAY AND ALOCKWOOD
HQ SOUTHCOM ALSO FOR POLAD
TREASURY FOR MMALLOY
NSC FOR JSHRIER
COMMERCE FOR 4431/MAC/WH/MCAMERON

E.O. 12958: DECL: 10/07/2018
TAGS: ECON EFIN EPET VE
SUBJECT: FALLING OIL PRICES: CLEAR BUT NOT PRESENT DANGER
FOR VENEZUELA'S ECONOMY

REF: A. CARACAS 1146
¶B. CARACAS 68
¶C. 2007 CARACAS 1003
¶D. CARACAS 1338
¶E. CARACAS 276
¶F. 2007 CARACAS 2228
¶G. CARACAS 844

Classified By: Economic Counselor Darnall Steuart for reasons 1.4 (b) and (d).

¶1. (C) Summary: Venezuela's economic model is dependent on ever-rising oil prices. As such, the economy is clearly vulnerable to reduced global demand for oil, an increasingly likely consequence of the current global financial crisis. With oil prices already down 25 percent from their historic highs in July, many analysts are asking whether there is a critical threshold price which, if sustained, would lead to an economic crisis in Venezuela in the next six to 12 months. Because the Bolivarian Republic of Venezuela (BRV) appears to have built up substantial reserves, both in the Central Bank and quasi-fiscal accounts, the government should be able to avoid an economic crisis in this timeframe given likely oil price scenarios. Many local economists believe that an average price of USD 80 per barrel for the Venezuelan export basket would expose severe problems in 2010 and require drastic action shortly thereafter. With an average price of USD 60 per barrel, severe problems would emerge in 2009 and require drastic action in 2010. Although a full blown crisis seems unlikely in the next 12 months, the recent fall in oil prices may be serving as a wake-up call to President Chavez and senior BRV leaders about Venezuela's economic problems. End summary.

## Unsustainable Growth

¶2. (SBU) Rebounding from a short recession in 2002 to 2003, Venezuela's economy registered annual real growth of 8 percent or higher from 2004 to 2007. This seemingly impressive growth was largely driven by a boom in private consumption made possible by massive increases in public spending. The spending increases, in turn, were made possible by rising oil prices, which almost doubled from 2004 to 2007. There is a dark side to Venezuela's economic

rebound, however. Because of political uncertainty, threats to private property, and an overvalued exchange rate, private investment in new productive capacity has been minimal. The huge increase in demand, therefore, has been met by increased utilization of existing capacity and, more importantly, by imports, which more than doubled in dollar terms from 2004 to 2007

¶3. (C) The dependence of this model on ever-rising oil prices is clear: should oil prices stabilize or fall, at some point the BRV would be forced to stop the growth in imports and government spending, and the economy would begin to contract. As Post has consistently argued, this economic model is unsustainable and will lead to an economic crisis such as a significant devaluation and/or recession in a timeframe largely determined by oil prices (refs A, B, and C). The current situation of high inflation and slowing growth is an indication of the problems the economy is already facing (ref A).

## Keeping Perspective: Oil Prices and the BRV's War Chest

¶4. (SBU) Shielded by currency controls, Venezuela's economy to date has not suffered greatly from first-order effects of the global financial crisis (ref D). On the other hand, it is extremely vulnerable to reduced global demand for oil, an increasingly likely consequence of the crisis. The recent decline in oil prices has led local analysts to ask whether there is a critical threshold price that would cause an economic crisis in Venezuela in the next year. In addressing this question, it is important to keep two points in mind. First, oil prices, while down from their record levels in July, are still high. The average annual price of the Venezuelan export basket was USD 33 per barrel in 2004, USD 45 in 2005, USD 56 in 2006, and USD 64 in 2007. It has averaged USD 101 to date in 2008, reaching a high of USD 122 in July and falling to USD 91 for the week of September 29. Barring a spectacular and immediate collapse in prices, in other words, the BRV will certainly earn far more in 2008 from petroleum sales than it ever has.

¶5. (SBU) Second, by all accounts the BRV has built up over the past four years a significant war chest of available funds, both in hard and local currency. As a large part of this war chest is purposefully held in accounts with little to no transparency (septel), no one is certain of the exact amount or the degree of liquidity. Current estimates put the total amount at above USD 100 billion, including international reserves held by the Central Bank (approximately USD 39 billion) and with the value of BRV local currency holdings calculated in dollars at the official exchange rate. The BRV can use this war chest as a cushion to mitigate the impact of a fall in oil prices in the short term, thus delaying the onset of a potential crisis.

## USD 60 to 80 per Barrel: The Problem Range

¶6. (C) Lower oil prices have implications for Venezuela's balance of payments and the BRV's fiscal position. Local economists calculate that average Venezuelan basket prices of around USD 80 per barrel in 2009 would result in a small deficit in the current account. (Note: This calculation assumes among other things that Venezuela produces and exports less oil than PDVSA claims - see refs E and F for doubts about PDVSA's numbers and implications for the balance of payments. End note.) From the fiscal perspective, Ecoanalitica, a local consulting firm, calculates that prices of USD 85 per barrel in 2009 would force the BRV to seek financing on the order of 4.5 percent of GDP. The BRV could manage the current account deficit and financing requirements in 2009 relatively easily by depleting its cushion. 2010 would not be so easy, however: faced with a growing need to

import and spend, and likely with declining oil revenue (assuming oil prices remained at USD 80 and oil exports kept gradually falling), the BRV would be under mounting pressure and would probably have to take drastic action, such as a significant devaluation, by 2011 at the latest.

¶7. (C) If the average Venezuelan basket price falls to USD 60 in 2009, which as of last month most local economists considered highly unlikely, the pressure would mount in 2009, and the BRV would probably be forced to take drastic action in 2010. Under this scenario, Banco Mercantil (strictly protect) estimates Central Bank reserves would drop to USD 19 billion by year-end 2009 (in comparison with the current USD 39 billion), a critical level given annual imports of roughly USD 50 billion. With oil prices at USD 60, Ecoanalitica's calculations put the BRV's financing needs at 9 to 10 percent of GDP for 2009, an amount that could be covered only by depleting the majority of its accumulated cushion.

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Comment
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¶8. (C) We do not expect Venezuela's economy to enter a crisis overnight. Stable or falling oil prices will have a profound impact, however, forcing President Chavez to strike a balance between depleting his war chest and suffering the political consequences of reining in spending and imports. BRV leaders seem to recognize this potential dilemma, though they have offered no serious plan to deal with it. Calling "austerity" the guiding principle for the pending 2009 budget, Chavez and Finance Minister Ali Rodriguez have recently pledged the elimination of superfluous spending on things like "travel, cars, cell phones, and parties." Like Chavez' June 2008 economic proposals (ref G), this pledge does not auger any fundamental change. (Note: Instead, it may reflect a strategy to divert money from regional governments where Chavista candidates suffer losses in upcoming elections (septel). End note.) If the BRV were to use its war chest to cushion an adjustment to a more productive economic model, the economy could conceivably emerge in a stronger position after several very difficult years. In the far more likely scenario that President Chavez continues his drive toward state control and vaguely defined models of "social production," an economic crisis is only a matter of time, with the timeframe largely determined by the price of oil. End comment.
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